Audit's® MARKET ANALYSIS OF SECURITIES OF REITS AND REAL ESTATE COMPANIES

Realty Stock Review

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MARKET COMMENT: REALTY STOCKS ARE NOW RESPONDING MAINLY TO MAJOR NEWS ITEMS

More and more the broad surge in realty stock prices is breaking up into a market in which individual stocks are responding to specific news. Our best indication is that the number of realty stocks making new highs has tended to fall a bit as a percentage of all stocks making highs. Most new highs can be traced to specific corporate news.

Florida Gulf Realty Trust hit a new high after announcing it signed a contract to sell all properties that could result in holders receiving liquidating payout of about $18/sh. A year ago FGLFS had hoped to sell out at $20/sh. but shares drifted near 14 when no buyer appeared. The buyer is an affiliate of Investors Central Management Corp. but properties will not wind up in ICM Property Investors, a REIT managed by ICMC.

Bay Financial Corp. hit a new high of $26.75, up about 16%, when it said current value of assets rose 21% to $41.02/sh. in its May fiscal year. At present the market prices BAY at about 34% discount from this value.

Other highs: **Universal Development** on conversion to limited partnership; new **Castle & Cooke** (RSR, June 28).

RANKING REVIEWS: THREE FINANCIAL SERVICE COMPANIES HOLD RANKS; EQUITEC KEEPS A

We begin this issue a more specific description of our Rankings of companies to provide more analytical insights for investors. We cite in each review both an overall Rank plus additional Ranks (from "A" to "E" in all cases) in the three subcategories we have found most useful, as follows:

--Earnings and dividend growth and stability, a 40% weight in overall Rank;
--Financial leverage, liquidity, and match of assets/liabilities, 40%;
--Exposure to outside forces; Management leverage and planning, 20%.

Equitec Financial Group Inc. ($16.50--NYSE) holds overall A Rank with these subgroup Ranks:

--<u>EPS/dividends</u> - <u>A</u>. Operating EPS has risen at 46.7% the past five years. EPS of $1.53 in the April 1985 year rose 17.7% from 1984. Dividends paid rose at 50.9% over five years and payout was just upped to 16¢ to yield 1.0%.

--<u>Financial</u> <u>measures</u> - <u>A</u>. $45 mil. face amount of debt (all subordinated and/or convertible debt) is 1.7 times net equity of $25.8 mil. before deduction of $28.6 mil. goodwill from two recent acquisitions (see below). Net book value before goodwill is $5.07/sh.,

RANKING REVIEW ISSUE

NOW AVAILABLE: Our new brochure describing our money management services and two new separate accounts (TARESA Accounts - The Audit Real Estate Securities Accounts).

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and negative 56¢ afterward. Audit follows the conservative financial practice of deducting goodwill in developing its statistical tables (p. 6-8 of June 28 issue) because goodwill is an intangible asset generally of limited value in bankruptcy or other extreme situation. But from a practical investors' view, book value is best viewed before the goodwill haircut. EFG liquidity is good and operating cash flow positive. Asset match is strong as longer-term assets are financed with long-term debt.

--Outside exposure - B. EFG has followed a well thought-out plan for expanding financial services, and within the last year acquired a securities management company (Siebel Capital Mgmt. with about $1.06 bil. under management) and a small S&L, renamed Equitec Savings Bank. EFG's goal has been to diversify away from its initial base in real estate syndications, now under a cloud from proposed tax law changes, into broader based financial services. Thus our B Rank in this sector reflects major improvement in controlling operating environment by diversifying away from exposure to governmental changes.

Operations: Sales of real estate programs still constitute the bulk (70%) of revenues but sales commissions to third-party sales reps erode margins. The big play in EFG is the growing base of assets under management, which rose 194% to $2.5 bil., mainly because Siebel added $1 bil. Asset management fees were only 19% of revenues but generated 55% of operating income. Siebel started managing fixed-income portfolios in 1985 and also began offering the first of a planned family of mutual funds. These and products of Equitec Savings will be sold thru EFG's 8,200 independent sales reps, mainly financial planners and broker-dealers. EFG plans offering consumer banking services to its 110,000 limited partner investors under the Savings Bank umbrella. Direct pension fund investment in real estate is also offered. As a service company, sales commissions and administrative costs made up the bulk of expenses, 72%. Pretax operating margin of 19% was up from 18%; EFG supports proposed corporate income tax cuts from 46% to 33% because it would have added 20¢ to EPS.

Countrywide Credit Industries Inc. ($9.88--ASE) maintains B Rank in its Feb. 1985 year. Subgroup Rankings for the Pasadena, Cal. mortgage banker are:

--EPS/dividends -B. CCR earnings are fairly volatile longer-term, mainly due to interest rate swings which cannot be fully hedged and continued heavy investment in expanding its loan origination office network. CCR netted 46¢ sh. in 1985, down 34%; 1985 benefitted from $13.5 mil. net revenue from sale of servicing, up 141%. Management decided to step up servicing sales (instead of retaining mortgage servicing rights) in view of current cash requirements and EPS objectives. Longer term, EPS have ranged from 18¢ to 70¢ with only modest overall growth. Cash dividends have also been somewhat volatile with the 24¢ payout last year down 11%.

--Financial measures - B. As a mortgage banker, CCR borrows under a $180 mil. credit line to warehouse mortgages (mostly single family conventional loans) for sale to investors. Assets thus include $133 mil. mortgage loans and $34 mil. finance receivables supported by $132 mil. commercial paper and secured bank loans. Total debt is thus 4.8 times $27.3 mil. equity; there is no general corporate debt so the realistic leverage ratio is low. Liquidity and cash flow are adequate for expansion.

--Outside exposure - C. CCR has invested heavily in building a nationwide loan origination office network to generate home mortgages and a growing array of related consumer products for sale to investors. Total offices increased 16% to 108 by year-end and CCR spent heavily to link these offices thru a computer network promising timely responses to changing markets, with a minimum of administrative layers between offices and top management. CCR has in recent years added mortgage banking service to manufactured housing; an N.A.S.D. broker/dealer selling higher-margined odd-lots of mortgage backed securities; a consumer oriented thrift and loan in Calif., plus insurance and title units. Network operating profits are sensitive to volume, and loans in process are up 52% recently. Servicing portfolio, a recurring income source, rose 17% to $967 mil.

The Hammond Co. ($5.00--OTC) holds C Rank on results of its Mar. 1985 fiscal year. The Newport Beach, Cal. based mortgage banker's subgroup Rankings are:

--EPS/dividends - D. EPS is quite volatile and THCO has reported losses in two of the past five years. It lost 36¢ sh. in the Mar. FY, vs. 71¢ profit. The loss resulted from a plunge in loan origination income to a 36¢ pretax loss; 32% decline in net interest income (difference between mortgage interest received and interest on related warehousing bank lines), and 42¢ pretax loss reserve to cover foreclosure losses disputed with FNMA. THCO pays no dividends.

--Financial measures - B. THCO borrows under $60 mil. credit lines to finance warehousing of loans prior to resale. Debt of $24.2 mil. (all bank lines) is supported by mortgages and is 2.8 times the $8.6 mil. equity, equal to $4.09/sh. Lower debt levels reflect an 8% drop in loan originations to $239 mil. Liquidity is adequate, although working capital fell 20% to $5.9 mil. as result of the loss reserve. The asset-/liability match is good. THCO was the first mortgage banker to sell multi-builder mortgage bonds collateralized by loans on new homes. It has sold $57 mil. of such bonds and at year-end $47.2 mil. CMO bonds payable were offset in THCO's balance sheet by $47.1 mil. receivables.

--Outside exposure - C. As a smaller mortgage banker, THCO is subject to intense industry competition. It has competed by (1) beginning the costly multi-builder bond program so it becomes a supply source for Wall Street firms marketing mortgages as securities, (2) increasing its servicing portfolio, by 13% to $570 mil., instead of selling servicing, and (3) winning approval from Calif. to open an S&L (Federal approval is yet to come).

RANKING REVIEWS: THREE INVESTMENT AND HOME BUILDERS STRENGTHENING POSITIONS

Koger Properties Inc. ($27.63--NYSE) maintains A Rank. The Jacksonville based investment builder develops suburban, mid-rise campus-type office parks in 21 Sunbelt cities for sale to three related entities: The Koger Co. (ASE), The Koger Partnership (publicly owned); and Koger Office Parks, subsidiary formed to build ten new office parks for sale to pension plans managed by Morgan Guaranty Trust Co., New York City. Ranks in subgroups:

EPS/dividends - A. Net income under generally accepted accounting principles was 55¢ per share in KOG's Mar. 1985 fiscal year, off 10%. But net cash flow is the real measure of KOG's performance and this has risen at 25.8% annually the past four years (since Koger Co. was spun off) to $1.95/sh. by Audit's calculations. KOG itself reports CFS equal to $2.57/sh., the main difference being 44¢ deferred income tax. About half of KOG's CFS comes from net rental income, half from sales to other affiliates under ongoing sales contracts. Dividends declared rose 20% in 1985 and have risen at 47% annually since the spinoff. About 70% of payout is tax-free return of capital. The $2.30 annual rate returns 8.3%.

--Financial measures - B. Total debt of $135.3 mil. is 3.5 times net shareholders' equity at cost of $38.7 mil. and 2.6 times equity plus accumulated depreciation. Book value plus depreciation is $6.68/sh. Unlike its sister Koger Co., KOG does not provide current appraised value of properties held in inventory for sale. However its 20.1% interest in Koger Partnership is valued at $2.12/sh. over cost. While leverage appears high based on cost, KOG believes its building methods add value (it builds many copies of prototype buildings, and controls work internally so that it believes it produces space at about 65% of cost for competitors). Properties are sold to affiliates at appraised values, which has historically been well above cost. On this basis we do not see leverage as excessive. Since most internally generated cash flow is paid as dividends, financing is obtained externally including $26 mil. forward funding against future property purchases. Part of KOG's liquidity rests upon continued ability of other entities to obtain funding: During 1985 Koger Co. raised $36.7 mil. thru stock sale; Partnership raised $33 mil. via sale of new

partnership units; and KOG itself raised $35.7 mil. thru sale of 1.38 mil. shs. Also, Morgan Guaranty provides all funding for the 10 centers being built for sale to it; KOG gets 10% fee for rendering building services plus half all future liquidation profits.

--Outside exposure - A. In the competitive suburban office market, KOG has maintained occupancies averaging over 90% by (1) keeping tight cost controls and using prototype designs to build at 65%-70% of competitors' cost; (2) leasing aggressively for three-five years to a mix of smaller tenants plus sales offices of major national companies, at rents it believes are 85% of competitive market rents. KOG normally builds small buildings of 50,000 sq. ft. or so, and can halt building if local markets soften (although one new prototype building has 100,000 SF). KOG has stayed in one property type, in carefully selected Sunbelt cities, and avoided mortgage financing giving profit shares to lenders. It believes the proposed tax changes would raise rents by 50% over 3-5 years because competitors would lose tax benefits.

Centex Corp. ($25.88--NYSE) stays at B Rank (a very high B). This Dallas homebuilding and contracting company's subgroup Ranks are:

--EPS/dividends - C. Operating EPS have been volatile, rising at 7.1% over five years and ranging from $2.08 to $0.98. EPS for the Mar. 1985 year of $2.01 was down 3%. In 1985 CTX spun off its energy subsidiary to focus upon homebuilding, contracting and building materials distribution. Homebuilding generated 53% of income before corporate costs in 1985, above the 46% average over five years; this segment has grown at 12.5% annually. CTX delivered 6,001 units and year-end backlog of 2,168 DU was level with 1984. CTX builds in 21 urban markets with Dallas/Ft. Worth and other Texas cities being 54% of deliveries and Fla./Ga. being 22%. Construction materials, mainly a very profitable cement operation to which CTX has added gypsum, produced 37% of income, on par with its 35% five-year average. General contracting income fell 21% to 10% of income, below its 19% average contribution. CTX has paid dividends consistently but raised payout relatively infrequently; the 25¢ rate returns 1%.

--Financial measures - A. Total debt of $138 mil. is 0.45 times $302 mil. equity, CTX's lowest leverage ratio in 15 years. Book value is $16.28 sh. Capital includes $169 mil. deferred taxes ($9.13/sh.) which would ultimately be paid at a lower 33% rate if proposed tax changes are enacted. CTX now generates about $100 mil. yearly net cash flow (about $5.40/sh.) and last year paid $35.9 mil. to retire 1.6 mil. shs. (or 8.1% of shs.) at $22.20/sh.

--Outside exposure - A. CTX has streamlined itself to perform well in competitive businesses. Free cash flow gives many options, and forward planning and execution seem excellent.

Fairfield Communities Inc. ($13.63--NYSE) also holds A Rank. The Little Rock developer of retirement and leisure communities has become a major national development company, active in homebuilding, timesharing, land sales, and resort operations. It operates 13 Sunbelt resort communities with 68,550 acres; 10 residential building sites; and a wholly owned finance subsidiary.

--EPS/dividends - A. FCI earned $1.49 primary and fully diluted in its Feb. 1985 year. EPS diluted have risen at 23.5% over the past five years and were up 16% last year. Homebuilding sales rose 63% to $77.8 mil., buoyed by Tuscon area building and $17.5 mil. housing sales in resort communities; operating margins eroded to 24% however. Timesharing sales, a big gainer in earlier years, were flat at $61.1 mil.; operating margins widened a bit to 72%. Lot sales fell 10% to $23 mil. but commercial property and land sales soared 277%, partly due to Eaton Intl. acquisition in 1983. Dividends have risen at 23.9% and 18¢ yields 1.3%.

--Financial measures - C. Debt of $167 mil. is 1.4 times $116 mil. equity, or $10.92/sh. Debt is short-term and matched against $125 mil. receivables. Operating cash flow to produce new product is negative, however.

--Outside exposure - A. In a very competitive business, FCI has diversified into a full-line developer.